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No. 828

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APR 19 1961
JAMES R. BROWNING, Clerk

In the Supreme Court of the United States

OCTOBER TERM, 1960

JOHN R. UPTON, ET AL., *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE RESPONDENT IN OPPOSITION

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

ROBERT N. ANDERSON,
CAROLYN R. JUST,
Attorneys,
Department of Justice,
Washington 25, D. C.

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 111-131) is reported at 32 T.C. 301. The opinion of the court of appeals (Pet. App. 1-14) is reported at 283 F.2d 716.

JURISDICTION

The judgment of the court of appeals was entered September 27, 1960 (Pet. App. 15.) The taxpayers' first and second petitions for rehearing were denied on December 19, 1960, and March 10, 1961, respectively. (R. 265, 269.) The petition for a writ of certiorari was filed on March 20, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1)

QUESTION PRESENTED

Whether the provisions of a will creating a trust required the trustees to retain sufficient royalty income to preserve the trust corpus, thereby entitling the trustees, rather than the income beneficiaries, to the deduction for depletion under Section 23(m) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> • • • • • • • • • •
>
> (m) *Depletion.* * * * In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.
>
> * * * * * * * * * *

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

> Sec. 39.23(l)-1. *Depreciation.* * * * In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust

computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. * * *

* * * * * * * * *

Sec. 39.23(m)-1. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.* * * *

* * * * * * * * *

(c) * * * The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See section 39.23(l)-1.)

* * * * * * * * *

STATEMENT

The will of William R. Sloan, who died on April 14, 1923, devised the residue of his estate to trustees (R. 113, 114):

> * * * [to] receive the rents, issues, profits and income of said property, and after paying all necessary and proper expenses incurred by them in the administration of their trust * * * [to] dispose of the net rents, issues, profits and income of said property as follows: * * *

The net income [1] was to be paid to the decedent's wife

[1] Subject to a small annuity for decedent's sister-in-law, who died in 1936.

for her life and then to his two daughters in equal shares. Decedent's wife died in 1945. His two daughters, the taxpayers,[2] are the present income beneficiaries of the trust. Upon the death of the taxpayers, the corpus of the trust is to be distributed to their issue or, if none, to designated charities. (R. 113-115; Pet. App. 1-2.)

The estate of the decedent was distributed on September 29, 1924. Among the assets distributed to the trustees were 107 shares of stock in the Pleasant Valley Farming Company, appraised at $32,100, and mineral rights in certain lands in the Cuyama Valley area of San Luis Obispo County, California, having a fair market value on the date of decedent's death of $5,445.25. (R. 115-116; Pet. App. 2-3.)

In 1943 the trust received, as a distribution from the Pleasant Valley Farming Company, an interest in oil-producing lands leased to the Standard Oil Company of California.[3] Prior to October 31, 1951, the trustees distributed all of the net royalties from the Standard Oil lease (aggregating $121,000) to the income beneficiaries, who in turn claimed the entire depletion deduction. (R. 117-118; Pet. App. 2-3.) Beginning on November 1, 1951, however, the trustees, for the reasons stated below, retained 27-1/2% of the Standard Oil royalties. Thereafter, the trust and the income beneficiaries divided the depletion deduction between them in proportion to the division of the royalties (Pet. App. 3).

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[2] John R. Upton is a party only because he filed joint income tax returns with his wife.

[3] The interest of the trust in the producing lands so leased was worth $19,289.99 at the time of the distribution. (R. 117.)

On June 19, 1948, the trustees entered into a written agreement with the Richfield Oil Company for the development of oil and gas from the mineral interests owned by the trust in the Cuyama Valley. In compliance with the terms of the agreement, the trustees, in filing of their nineteenth account and report in the trust proceeding, asked the Superior Court of the State of California in and for the County of Alameda for instructions as to their authority to enter into the Richfield agreement (which might extend beyond the duration of the trust) and also for instructions as to the distribution of the royalties under both the Richfield agreement and the Standard Oil lease. The guardian *ad litem* appointed for the living and unborn remaindermen maintained that all of the royalties, being from the sale of a wasting asset, should be treated as a return of capital and be credited to principal. The trustees and the taxpayers, on the other hand, argued that all of the royalties were income within the meaning of the will and should be distributed to the income beneficiaries (R. 118-121; Pet. App. 3-4).

On May 19, 1953, the Alameda County court entered a decree (App. 9-71)[*] confirming the authority of the trustees to enter into the Richfield agreement or any other mineral lease "provided that the royalty income produced" therefrom "be reasonably apportioned or allocated between the present income beneficiaries and the trustees" as provided in the decree. The decree instructed the trustees to allocate 72-1/2% of the royalty income from the Richfield agreement and the Standard Oil lease to the income beneficiaries and

[*] "App." refers to the appendix to the taxpayers' brief in the court of appeals, where the decree is set out in full. It is also printed in part at R. 39-47.

27-1/2% to the trustees as "retained royalties." For purposes of distribution of the corpus upon termination of the trust, it was ordered that the retained royalties "be treated in all respects as if it were part of the property distributed to the trustees by said decree of final distribution * * *." No appeal was taken from the decree, and it became a final and conclusive adjudication of property rights. (R. 120-122; Pet. App. 4-5.) It was stipulated that the proceeding was adversary in nature and fully and fairly argued to the court. (R 108.)

In compliance with the Alameda County court's decree, the trustees, during the taxable years 1952 and 1953, distributed to the taxpayers 72-1/2% of all gross royalties received by the trust, and retained 27-1/2%. (R. 122.) In the trust's income tax returns for 1952 and 1953, the trustees deducted 27-1/2% of the royalties retained by them as a depletion allowance. In their individual returns, the taxpayers similarly deducted 27-1/2% of the royalties which had been distributed to them. The Alameda County court was advised of that treatment in the twenty-first and twenty-second accounts filed by the trustees for the calendar years 1952 and 1953. Both accounts were approved by the court. (Pet. App. 5.)

The Commissioner disallowed the depletion deductions claimed by the income beneficiaries and determined that the trustees were entitled to the full depletion deduction.[5] The Tax Court and the court of appeals upheld the Commissioner's determination. (R. 123, 130; Pet. App. 5, 13.)

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[5] The trustees have filed protective claims for refund, which have been held pending the outcome of this case. (Pet. App. 5.)

ARGUMENT

The decisions below are correct. There is no conflict in decisions or other reason warranting further review.

1. Section 23(m) of the Internal Revenue Code of 1939 provides that in the case of property held in trust the allowable deduction for depletion shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. The regulations (Treas. Regs. 118, Sections 39.23(l)-1 and 39.23(m)-1, *supra*, pp. 2-3) provide that where a trustee is required by the terms of the instrument creating the trust to keep the trust corpus intact by the retention of a portion of the income, the deduction is to be granted in full to the trustee. That provision of the regulations, which was taken almost verbatim from the committee reports[6] and has been in effect for over 30 years,[7] is plainly a reasonable interpretation of the statute. The depletion deduction, like the depreciation deduction to which the same provision applies, is designed to compensate for the loss of capital resulting from the exhaustion of a wasting asset. Hence when the testator seeks to protect the remaindermen against the loss of capital by requiring the trustees to retain a sufficient amount of current income to preserve the trust corpus intact, it is the trustees rather

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[6] On Section 23(l) of the Revenue Act of 1928, 45 Stat. 791, the predecessor of Section 23(m) of the 1939 Code. S. Rep. No. 960, 70th Cong., 1st Sess., p. 20 (1939-1 Cum. Bull. (Pt. 2) 409, 423); H. Rep. No. 1882, 70th Cong., 1st Sess., pp. 11-12 (1939-1 Cum. Bull. (Pt. 2) 444, 445).

[7] See Article 201 of Treasury Regulations 74 (1929 ed.), issued under the Revenue Act of 1928.

than the current income beneficiaries who should receive the benefit of the depletion deduction. See *Commissioner* v. *Netcher*, 143 F.2d 484 (C.A. 7), certiorari denied, 323 U.S. 759; *Newburg* v. *United States*, 57 F. Supp. 168 (Ct. Cls.), certiorari denied, 323 U.S. 802.

The courts below properly applied the statute and regulations to the facts of this case. The 1953 decree of the California court, entered in an adversary proceeding, was fully binding as an adjudication of property rights under the trust instrument. *Lang* v. *Commissioner*, 304 U.S. 264; *Blair* v. *Commissioner*, 300 U.S. 5; *Freuler* v. *Helvering*, 291 U.S. 35; *Poe* v. *Seaborn*, 282 U.S. 101. That decree properly interpreted the Sloan will as requiring the trustees to maintain the corpus of the trust by retaining 27-1/2% of the royalties, with such "retained royalties" to be treated in all respects as if they were part of the property distributed to the trustees by the decree of final distribution. (App. 45, 46-47, 55, 66-68.) The will authorized the trustees to distribute only "net rents, issues, profits and income." (R. 86.) The primary issue on which the trustees asked the California court for advice was whether all or some part of the oil royalties were a return of capital and should be held as part of the principal of the trust. (Pet. App. 7.) The guardian *ad litem* for the remaindermen argued that all the oil royalties constituted principal of the trust estate, and no part was income (App. 15-16; Pet. App. 8), while the income beneficiaries contended that no part of the royalties was a return of capital or should, in whole or in part, be held to be a part of the principal of the trust. (App. 17; Pet. App. 8.) In ordering the trustees to retain a portion of the royalties, the court resolved the controversy by requiring the trustees to

set up a reserve to preserve the corpus of the trust for the benefit of the remaindermen. Such an interpretation of the will was fully in accord with the established rule of trust law that, where income is payable to one beneficiary and principal to another, the trustee is under a duty to set aside part of the receipts from the property as an amortization fund, and thus to preserve corpus. See *Parker* v. *Riley*, 250 U.S. 66; 3 Scott, *Trusts* (2d ed.), Sec. 239; *Restatement of Trusts* (2d ed.), Sec. 239. The very amount of the royalties ordered retained, 27-1/2%, indicates that it was intended to be a reserve for depletion, and was ordered to be retained on the theory that, in conformity with the testator's intention, that portion represented a return of capital and not "income" available to the income beneficiaries. No other basis for the court's order is apparent, and the taxpayers have suggested none. Thus, the courts below have not read words into the will (Pet. 13), but have simply given effect to a decree of the California court adjudicating property rights and properly interpreting the will in accordance with the obvious intent of the testator.

The taxpayers argue (Pet. 15) that subsequent decrees of the California court approved the allocation of the depletion deduction 72-1/2% to the taxpayers and 27-1/2% to the trustees. As the court below pointed out (Pet. App. 9), however, the subsequent decrees merely approved the trustees' accounts in non-adversary proceedings. Nor does the decree dated January 11, 1961 (Pet. App. 24-41), lead to a different result. That decree, approving the trustees' 28th account, was likewise entered in non-adversary proceedings and was an attempt simply to change the characterization of the 1953 decree, for tax purposes, without otherwise

affecting any substantive rights. It has, moreover, admittedly not become final. (Pet. 9, 16.) The state court's approval of the deduction claimed by the trustees for federal tax purposes is immaterial in any event. The deduction allowable is a federal question, and state law is relevant only in determining the substantive rights and duties created by the will to which the federal criteria are to be applied. See *Gallagher* v. *Smith*, 223 F.2d 218, 222 (C.A. 3). The 1953 decree, on the other hand, did adjudicate substantive property rights and was properly given effect by the courts below. *Freuler* v. *Helvering*, 291 U.S. 35, 45; *Blair* v. *Commissioner*, 300 U.S. 5, 9.

2. The earlier decision of the court below in *Little's Estate* v. *Commissioner*, 274 F.2d 718 (C.A. 9), was fully distinguished by the court in its opinion in this case (Pet. App. 11-13), and there is no intra-circuit conflict. In this case, unlike *Little*, the will gave the trustees no discretion to retain income or to determine what was income and what was principal; the will was mandatory in directing that all *income* be distributed to the income beneficiaries. A portion of the royalties could be, and was, withheld from the income beneficiaries only because the trust instrument, as interpreted by the California court, required such retention in order to preserve the *corpus* of the trust.

Under the regulations, in turn, where the trust instrument, properly interpreted, "provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will

be granted in full to the trustee" (Sec. 39.23(l)-1, *supra*). The courts below properly so held.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
Solicitor General.

LOUIS F. OBERDORFER,
Assistant Attorney General.

ROBERT N. ANDERSON,
CAROLYN R. JUST,
Attorneys.

April, 1961

☆ U. S. GOVERNMENT PRINTING OFFICE 1961—591306/P. O. 1203